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Via Electronic Filing

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W., TW-A-325
Washington, DC 20554

Re: *Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*
CC Docket No. 02-33

Dear Ms. Dortch:

BellSouth provides this response to a letter recently filed on behalf of AT&T regarding proposals made for accounting issues in the broadband proceedings.¹ Fundamentally, the debate over broadband issues must be decided by the Commission on a policy level. While all of the rules, most of which grew up in a voice world, are extremely complex and archaic, the desired outcome is not – rapid deployment of broadband availability to everyone.² For the Commission to engineer this desired goal, it must carefully understand the cause and effect of the retention and application of the rules that will govern all aspects of broadband deployment. The accounting rules that are the subject of the present debate, are all within the Commission's discretion to revise in its efforts to achieve the desired effect of widespread deployment.

¹ Letter from David L. Lawson, Sidley Austin Brown & Wood LLP, Counsel for AT&T Corp., to Marlene Dortch, Secretary, Federal Communications Commission, CC Docket No. 02-33 (July 31, 2003) ("AT&T Letter"). MCI filed a letter making many of the same arguments offered by AT&T. See Letter from Richard S. Whitt, Director, Federal Advocacy, to William F. Maher, Chief, Wireline Competition Bureau, Federal Communications Commission, CC Docket No. 02-33 (July 29, 2003).

² Indeed, in the recent *Triennial Review Order* the Commission very clearly expresses its goal of broadband deployment and its obligation to do so pursuant to Congress' mandate under Section 706 of the 1996 Act. *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, et al.*, CC Docket No. 01-338, *et al.*, *Report and Order and Order on Remand and Further Notice of Proposed Rulemaking*, ¶¶ 242, 541 (rel. Aug. 21, 2003) ("*Triennial Review Order*").

Contrary to the claims in AT&T's letter, the results of harmful effects that application of the current accounting rules will have on broadband deployment are palpable.

Cable modem service currently dominates the broadband market and there are no signs of this trend changing. Unless incumbent local exchange carriers ("ILECs") are relieved from cost allocation requirements for broadband investment, the Commission's goal of provider parity³ will not be realized among broadband providers. The cost allocation rules pose the sort of regulatory burdens that will significantly diminish any regulatory relief offered by the Commission. The Commission's goal should be to implement provider parity, not merely service parity. If the Commission were to require ILECs to allocate joint and common costs for broadband services, it would place ILECs at very burdensome regulatory odds with cable modem providers. This would not only lead to slower deployment but would also allow cable modem providers to entrench a dominance that cannot be overtaken by any competitor. In the end, this will lead to fewer choices for consumers.⁴

AT&T derides BellSouth's position that the accounting rules have any negative impact on broadband deployment, dismissing the cost allocation process as merely a small administrative task that can be performed with "no unusual burden."⁵ Such a statement is redolent with the hypocrisies that AT&T exhibits regarding cost allocation and its necessities under the current regulatory environment. AT&T is well aware of the extreme complexities of allocating joint and common costs among different services. Indeed, it would not be an understatement to say that requiring ILECs to allocate joint and common costs to broadband services would be the exception that would swallow any other broadband relief the Commission might grant.

Although the letter makes numerous claims, the arguments offered by AT&T fall under two basic categories – the alleged need for accounting rules to protect consumers and the impact of Section 254(k) of the Telecommunications Act of 1996 ("1996 Act"). Neither of these arguments impedes the Commission from fulfilling what are not only a recognized need but also a Congressional mandate to ensure rapid deployment of broadband services to all Americans.⁶

³ *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, et al.*, CC Docket No. 02-33, *et al.*, *Notice of Proposed Rulemaking*, 17 FCC Rcd 3019, 3023, ¶ 6 (2002) (Commission's principle and policy goal to develop a consistent analytical framework across multiple platforms) ("*Broadband Title I Notice*").

⁴ As Verizon points out in its *ex parte* filed on June 26, 2003, at 4-5, one only needs to look at the record of the Video Dial Tone proceeding to witness such complexities and to understand the negative impacts of nonsensical accounting regulations.

⁵ AT&T Letter at 3.

⁶ See Section 706 of the 1996 Act. Few issues are more important to economic growth and individual lives than wide scale broadband deployment. See also *Triennial Review Order*, ¶¶ 242, 541; *Deployment of Broadband Networks and Advanced Telecommunications*, Docket No. 011109273-1273-01, National Telecommunications and Information Administration; *Broadband Title I Notice*, 17 FCC Rcd at 3020-21, ¶ 1 ("The widespread deployment of broadband

The Commission took important steps to realize that goal with reduced regulation of broadband services in the *Triennial Review Order*. The effects of those important deregulatory steps must not be undone in the current proceeding, but the Commission must move forward with further changes that are necessary to achieve the Commission's desired goal. Such changes must include not only the deregulation of broadband services contemplated in the *Broadband Title I Notice*, but also must include relief for ILECs from allocating joint and common costs associated with those services.

I. Price Cap Regulation Eliminates the Need to Allocate Joint and Common Costs Between Regulated and Nonregulated for Broadband Services.

The current cost allocation rules grew out of the *Computer Inquiry*⁷ line of decisions that allowed AT&T and the BOCs to offer un-regulated and regulated services on an integrated basis. In doing so, however, the Commission applied a set of accounting safeguards to these carriers to ensure that a "cross-subsidy" did not occur. The Commission established these safeguards in its *Joint Cost Order*,⁸ which required carriers to allocate all costs, including joint and common costs, between unregulated and regulated activities. The Commission very specifically stated in numerous places throughout this *Order* that protection of interstate ratepayers through prevention of cross-subsidy was the purpose of the proceeding.

[I]nsuring just and reasonable rates for services that remain subject to regulation requires guarding against cross-subsidy of nonregulated ventures by regulated services, and that cross-subsidy can result either from the misallocation of common costs or from improper intracorporate transfer pricing.⁹

We reaffirm that protecting ratepayers from unjust and unreasonable interstate rates is the primary purpose behind the accounting separation of regulated from non-regulated activities, just as it is the purpose behind all of our accounting and cost allocation rules. *Our commitment to cost-*

infrastructure has become the central communications policy objective of the day. It is widely believed that ubiquitous broadband deployment will bring valuable new services to consumers, stimulate economic activity, improve national productivity, and advance economic opportunity for the American public.").

⁷ The cite to the *Computer Inquiry* line of decisions can be found in the *Broadband Title I Notice*, 17 FCC Rcd at 3036-37, n.68.

⁸ *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities; Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to Provide for Nonregulated Activities and to Provide for Transactions Between Telephone Companies and their Affiliates*, CC Docket No. 86-111, *Report and Order*, 2 FCC Rcd 1298 (1987) ("Joint Cost Order").

⁹ *Joint Cost Order*, 2 FCC Rcd at 1303, ¶ 33.

*based rates demands close attention to the manner in which the costs a company uses to support its interstate and access tariff filings are separated from other costs of the company.*¹⁰

Since the release of the *Computer Inquiry* orders and the *Joint Cost Order*, pricing of interstate services for most ILECs has moved to price cap regulation with pricing flexibility for many services. Regardless of the statements made by AT&T, price regulation as it exists for BellSouth, and most ILECs, eliminates the need for cost allocation. Indeed, even the Commission, as well as federal courts, have recognized that “because price cap regulation severs the direct link between regulated costs and prices, a carrier is not able automatically to recoup misallocated nonregulated costs by raising basic service rates, thus reducing the incentive for the BOCs to allocate nonregulated costs to regulated services.”¹¹ Significantly, the Commission’s statement regarding price cap regulation came before the elimination of sharing and the lower formulas cost adjustment (“LFAM”)¹² – the only elements of price cap regulation that could potentially create a direct link from costs incurred to the rate increases. With these eliminations, there is now truly no link between an increase in costs directly causing an increase in prices.

AT&T is well aware of the impact of price cap regulation on the occurrence of costs and the setting of prices. Although it now attempts to dismiss the obvious and have the Commission retain its cost allocation rules on the basis that “the federal price cap system does not eliminate the Bells’ incentives to misallocate costs,”¹³ AT&T certainly believes in the effectiveness of price cap regulation for such functions when it suits its purpose. When seeking to have the Commission’s accounting rules revised as applying to AT&T’s services subject to price cap regulation, AT&T fully acknowledged that “with respect to AT&T’s services still subject to

¹⁰ *Id.*, ¶ 37 (emphasis added).

¹¹ *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I Local Exchange Company Safeguards*, CC Docket No. 90-623, *Report and Order*, 6 FCC Rcd 7571, 7596, ¶ 55 (1991), *California v. FCC*, 39 F.3d 919 (9th Cir. 1994), *cert denied*, 514 U.S. 1050 (1995); *see also*, *California v. FCC*, 39 F.3d at 926-27; *United States v. Western Elec. Co.*, 993 F.2d 1572, 1580 (D.C. Circuit), *cert denied*, 510 U.S. 984 (1993) (“[price cap regulation] reduces any BOC’s ability to shift costs from unregulated to regulated activities, because the increase in costs for the regulated activity does not automatically cause an increase in the legal rate ceiling.”).

¹² LFAM was eliminated for any price cap ILEC that chose to take advantage of pricing flexibility for access services. All of the major ILECs have taken advantage of pricing flexibility and thus have lost any right to LFAM.

¹³ AT&T Letter at 5. AT&T dusts off the same argument – alleging that ILECs have an incentive to misallocate costs under price cap regulation – that it has made in various proceedings regarding rules affecting BOC’s Section 272 affiliates used for the provision of interLATA telecommunications services. AT&T’s strained position, however, is simply incorrect. *See* Declaration of Timothy J. Tariff, ¶¶ 21-24, attached to Reply Comments of Verizon, CC Docket No. 96-149 (filed Sept. 24, 2002).

price caps, the specifics of AT&T's price cap plan eliminate any ability or incentive to shift costs."¹⁴ AT&T went on to conclude "[i]n short, the basic assumption of the cost-shifting/cross-subsidization theory (i.e., that a regulated carrier can recover inflated transfer prices or other shifted costs through higher regulated price levels) is entirely inapplicable to AT&T . . . for services subject to AT&T's price cap regulatory system."¹⁵ AT&T's flip-flop on the effectiveness of price cap regulation underscores its disingenuous position.

In its attempt to now disavow its past acceptance of price cap regulation to eliminate a carrier's incentive to misallocate costs between regulated and nonregulated services, AT&T also argues that the Commission continues to apply the cost allocation requirements even though price cap regulation had been implemented for ILECs. AT&T cites the Commission's *Accounting Safeguards Order*¹⁶ noting that the Commission "appl[ied] those rules to a variety of nonregulated ILEC activities."¹⁷ In making its findings in that *Order*, however, the Commission reviewed the necessity of continuing the cost allocation requirements of Part 64 in light of price cap regulation but found that because of sharing, LFAM, and the fact that some intrastate services remained under rate of return regulations that carriers may still have an incentive to "assign a disproportionate share of costs to regulated accounts." The Commission stated, however, "[w]e recognize that changes in the competitive conditions of local telecommunications markets in the future may cause us to re-examine the continued need for our Part 64 cost allocation rules."¹⁸ Since that time, the marketplace and the regulatory paradigms have shifted. Competition has increased and the Commission has eliminated, for large ILECs, the sharing and LFAM elements from price cap regulation, the only remaining elements that could have created potential incentives for price cap ILECs to shift costs.¹⁹ Moreover, the Commission recently adopted the CALLS plan, which is "an integrated access reform/universal

¹⁴ Comments of American Telephone and Telegraph Company, CC Docket No. 93-251, at 11 (filed Dec. 10, 1993).

¹⁵ *Id.* at 13.

¹⁶ *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, *Report and Order*, 11 FCC Rcd 17539 (1996) ("*Accounting Safeguards Order*").

¹⁷ AT&T Letter at 4.

¹⁸ *Accounting Safeguards Order*, 11 FCC Rcd at 17661, ¶ 271.

¹⁹ See *Price Cap Performance Review for Local Exchange Carriers; Access Charge Reform*, CC Docket Nos. 94-1 and 96-262, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, 12 FCC Rcd 16642, 16700, ¶148 (1997) ("*1997 Price Cap Review Order*"), *aff'd in part, rev'd in part*, *United States Telecom Ass'n v. FCC*, 188 F.3d 521 (D.C. Cir. 1999). See also *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers; and Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, CC Docket Nos. 96-262, 94-1, 98-157 and CCB/CPD File No. 98-63, *Fifth Report and Order and Further Notice of Proposed Rulemaking*, 14 FCC Rcd 14221, 14304, ¶ 162 (1999) ("*Pricing Flexibility Order*").

service plan that restructured access rates to remove implicit subsidies. Rates under CALLS were not based on the development and reporting of costs under any of the Commission's accounting and reporting rules."²⁰

Finally, most states, all states in BellSouth's territory, are now under price caps for intrastate services. Thus, it is clear that cost allocation is not necessary to ensure just and reasonable rates or to guard against cross-subsidization. Moreover, just because some LECs may remain under rate of return regulation for interstate services and some states may continue rate of return for intrastate services is no reason to require all carriers to follow the Commission's costs allocation rules. Regardless of how broadband is treated within the Commission's accounting system, in the rate of return states, rates may be based on the cost of a stand-alone voice network.

AT&T further attempts to discredit the significance price cap regulation has on the elimination of cost allocation by suggesting that use of common facilities for both regulated and un-regulated services provides the LECs with operating efficiencies that will not benefit the ratepayer and instead cause these ratepayers to invariably overpay for regulated services unless cost allocation occurs. This flawed argument fails for two reasons. First, the very purpose of price cap regulation was to incent carriers to increase returns by creating efficiencies in their operations or by developing new services that customers want. Ratepayers are protected in this environment by maximum caps on prices that carriers may not exceed. To suggest that ratepayers must receive the benefit of every efficiency that a carrier obtains under price cap regulation without sharing, denies the very essence of the system. No one can seriously suggest that price cap regulation has failed and the Commission should return to rate of return regulation. Moreover, as discussed previously, AT&T certainly embraced the philosophy of price cap regulation when seeking it for itself, and cannot legitimately argue that the philosophy is now flawed when applied to others.

Second, price caps also protect ratepayers because ILECs subject to price cap regulation cannot raise prices if for price cap services if the ILECs become more inefficient. The fact of the matter is that AT&T's raises the specter of consumer's paying unreasonable prices but price cap regulations was designed specifically to regulate prices and insure that they remain just and reasonable. Cost allocation is a mechanical process unrelated to price setting or price regulation.

II. The Commission has no statutory obligation to apply cost allocation requirements to the common costs a BOC incurs to provide broadband services.

In addition to AT&T's rejection of the effectiveness of price cap regulation to adequately ensure ratepayers will receive just and reasonable rates for regulated services, AT&T also rejects the Commission's authority to provide the relief requested by BellSouth because of Section 254(k) of the 1996 Act. AT&T contends, "even if it made sense to do so, the Commission could not exempt broadband services from its existing cost allocation rules, unless and until it first implemented new cost allocation rules," because "the Commission codified that section's

²⁰ Comments of United States Telecom Association, CC Docket 00-199, at 5 (filed Feb. 13, 2001) ("USTA Comments").

prohibition on cross-subsidization.”²¹ Neither the statute nor the Commission’s implementing rules, however, require the Commission to apply the cost allocation rules to broadband.

Section 254(k) prohibits a carrier from using services that are not competitive to subsidize services that are competitive. Additionally, it requires the Commission, through the establishment of any *necessary* cost allocation rules, accounting safeguards, and guidelines, to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.²² Allocating joint and common costs to broadband, however, will do nothing to ensure that the objectives of Section 254(k) are met. Indeed, regardless of AT&T’s posturing, it offers nothing to demonstrate that an allocation of costs is necessary in this situation to prohibit competitive services being subsidized by noncompetitive services. As discussed extensively above, no matter what amounts remain classified as regulated costs, the price for the services charged to customers is established pursuant to the price cap formulas. And, price caps were implemented to ensure that a carrier could not increase prices for services subject to price caps to offset prices for services that are not subject to price caps.²³

As for universal service, the statute plainly gives the Commission discretion to determine what regulations may be *necessary* to achieve the purpose Section 254(k) sought to accomplish. There is little question that neither the application of existing cost allocation rules, nor the invention of new cost allocation, as AT&T suggests, is necessary to ensure that services within the definition of universal service do not incur an unreasonable share of the costs of the facilities used to provide those services. Congress enacted this section with the intention of ensuring that all regions of the nation would have access to basic and advanced telecommunications services and information services. Moreover, Congress intended that such services be available at reasonable and affordable rates. Realizing that costs incurred to provide such services to some regions would be far greater than rates affordable to those end users, the establishment of a fund was necessary to provide carriers with economic resources necessary to ensure that the cost for facilities those carriers use to provide services were not borne disproportionately by the carrier. Congress also intended, however, that such costs were not borne disproportionately by the fund. Significantly, the Commission’s mechanism that it established to determine the contributions to

²¹ AT&T Letter at 4.

²² The Commission codified this section in Part 64, “A telecommunications carrier may not use services that are not competitive to subsidize services subject to competition. Services included in the definition of universal service shall bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.” 47 C.F.R. § 64.901(c).

²³ The price cap limits are set by the Commission to ensure that rates remain within a zone of reasonableness and are established pursuant to the price cap index, which is adjusted based on the gross domestic product, and a pre-established productivity factor. Prices are held to a maximum level by the cap. Customers are also protected from cross-subsidization by the grouping of services in price cap baskets, which prevents a carrier from raising rates in one basket and lowering them in another to the detriment of the customers using the services in the first basket.

and distributions from the fund divorce carriers' costs from the process. Contributions to the Federal universal service fund are based on interstate retail revenues. And, the above discussion unequivocally shows that price cap carriers no longer determine prices to customers based on costs. Because a carrier's revenue is based on the prices it charges customers, cost allocation will not affect the contributions to the universal service fund. Moreover, distributions from the USF are based on a hypothetical cost model and are not based on the Commission's Part 32 or Part 64 cost structure. Because contribution and distributions are not affected by cost allocation, application of the cost allocation rules would have no connection to objectives the Commission desires to achieve.

For these reasons, as well as the price cap regulation issues discussed above, it is not necessary to apply cost allocation rules to the joint and common costs in the provision of broadband services. Clearly, cost allocation of joint and common costs for the BOCs' provision of broadband services is not *necessary*. The Commission must evaluate the necessity and application of the rules in the light of what the Commission and the statute want to prevent or hope to encourage now and in the future. As the D.C. Circuit recently found "it is reasonable to construe 'necessary' as referring to the existence of a strong connection between what the agency has done by way of regulation and what the agency permissibly sought to achieve with the disputed regulation."²⁴ The Commission seeks to achieve a universal service fund that does not fund services not within the definition of universal service. The Commission has taken all the steps necessary to achieve that purpose. Blindly applying the cost allocation rules to broadband services simply because they may have been applicable at some point in the past if the Commission had implemented a different form of universal service mechanism is not in the public interest and sustains no nexus between such regulation and the goals of the Congress or the Commission.

One other issue that should be noted is the fact that Section 254(k) is not limited to BOCs but applies to all telecommunications carriers. If the Commission applies the current rules to BOCs, even though none of the allocations will affect the contributions to nor distributions from the universal fund, then the same rules must be applied to all telecommunications carriers providing common carrier services under Title II. This would include interexchange carriers ("IXCs"), as well as competitive local exchange carriers ("CLECs").

III. Universal Service Issues

AT&T takes issue with BellSouth's request that the Commission implement a fair and equitable situation regarding contributions to the universal service fund. Today, cable modem providers do not contribute to the universal service fund for the provision of broadband services. The service offered by cable modem providers is exactly the same service offer by BellSouth. The Commission recognized this fact in the *Cable Modem Proceeding*.²⁵ Yet, cable modem

²⁴ *Cellular Telecoms. & Internet Ass'n v. FCC*, 330 F.3d 502, 512 (D.C. Cir. 2003).

²⁵ *Inquiry Concerning High Speed Access to the Internet Over Cable and Other Facilities*, GN Docket 00-185.

providers are not required to contribute to the universal service fund while BellSouth and other telecommunications carriers do. BellSouth points out that this requirement adds approximately \$3.00 per customer per month to BellSouth's costs related to this service. BellSouth's point is that DSL services are unfairly disadvantaged by this contribution when the dominant providers of the service, cable modem providers, do not incur the same expense.

AT&T first alleges BellSouth's position to be without merit because cable modem providers do not offer wholesale transport services. While AT&T is correct that cable modem providers are not required by regulatory compulsion to provide wholesale services, another regulatory requirement that DSL providers must endure that cable modem providers do not, is that cable modem providers do compete in many markets for wholesale customers.²⁶ In every situation where cable modem providers are offering wholesale services to ISPs they are competing with ILECs's DSL service for that business. The added cost of the USF contribution is more than significant enough to influence an ISP's decision to choose cable modem over DSL for transport. AT&T is simply wrong in asserting that it does not represent a "real competitive disadvantage."²⁷

BellSouth is confused by AT&T's conclusion that BellSouth's request that the Commission "remove wireline DSL revenues (wholesale and retail) from the USF contribution base on an interim basis, or unless and until a similar obligation is imposed evenhandedly on all competing services including cable modem service" cannot be granted because it would run afoul of the Administrative Procedures Act.²⁸ AT&T reaches this conclusion based on paragraph 73 of the *Broadband Title I Notice*, which states that during the "pendency of this proceeding, [the Commission] continue[s] to require all [telecommunications] carriers to make universal service contributions in the same manner required today."²⁹ BellSouth, however, is not requesting that the Commission remove the USF contribution obligation during the pendency of this proceeding, but asking that as a result of the proceeding the Commission's order address this issue of inequity and either remove the obligation from BOCs or impose a similar obligation on all service providers. The reference to the interim basis was to reflect the fact that if the Commission does not address the entire USF treatment in this proceeding, (e.g., taking up the obligation of whether to impose a contribution requirement on cable modem providers in the *Cable Modem Proceeding*), the Commission should remove the BOCs' contribution obligation until the matter is finally resolved. BellSouth assumes that AT&T does not purport that the Commission cannot take up the issue of USF contribution in its order in this docket considering that in paragraphs 69 through 72 of the *Broadband Title I Notice* the Commission summarizes its current USF contribution rules and then specifically states that it seeks "comment on whether these requirements and their basis in our rules and precedents are appropriate and consistent with

²⁶ *See id.*

²⁷ AT&T Letter at 7.

²⁸ *Id.*

²⁹ *Broadband Title I Notice*, 17 FCC Rcd at 3052, ¶ 73.

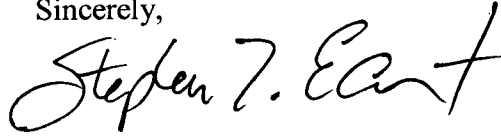
Marlene Dortch, Secretary

August 26, 2003

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our tentative conclusions regarding the statutory classification of wireline broadband Internet access.”³⁰

Sincerely,

A handwritten signature in black ink that reads "Stephen L. Earnest". The signature is written in a cursive, flowing style with a large, stylized "S" and "E".

Stephen L. Earnest

SLE:lb

³⁰ *Id.* at 3051-52, ¶ 72.